

# Legal perception and finance: when the perception matters more than the actual law

*How people perceive the quality of the law can affect companies in many ways. **Gerhard Schnyder, Anna Grosman, Kun Fu, Mathias Siems, and Ruth V. Aguilera** explore the underdeveloped role of legal perceptions in initial public offerings (IPOs), when companies list their shares in a stock exchange. They find that what drives IPO valuation is how shareholder protection laws are perceived, rather than the actual quality of the legal protection.*

It is often said that perception matters more than the actual underlying rule. Say you try to discipline a child, and you write a set of rules on the kitchen board, about their screen time, homework, house chores etc, but it stops there – you do not consistently monitor how the child abides by the rules, or discipline the child in case of misbehaviour. Over time, the child's perception of these rules will be different from what the rules actually are. Thus, what matters in the end, if you want your child to follow the rules, is the perception of these rules. For the parent, the implication is that what matters is the *signal* that the rules send and how the child perceives that signal.

In an economic context, this analogy from a parent's everyday life highlights the importance of focusing on the perception of law and how it matters for companies relative to the actual law. In a recent [article](#) on legal perception and finance, we argue that the perception of the quality of law should be considered alongside the quality of law and firm-level corporate governance practices. We focus on Initial Public Offerings (IPOs) across a large number of countries, and find strong support for the claim that the perception of the quality of law is more important than its actual quality to explain the post-IPO firm value. This effect remains no matter whether the law's quality is correctly perceived or misperceived.

One of the novelties of our study is the focus on "legal signalling" which we model theoretically and test empirically. This view focuses on the impact that law has on the legitimacy (as opposed to the efficiency) of economic activities. Laws can have an impact on economic activity through increased efficiency and decreased transaction costs (the standard view). Yet, the law can also have an impact on behaviours by influencing people's perception of a given legal system or the companies operating in it. We call this aspect "legal perception". The legal signalling view suggests that laws are not just transaction-cost reducing devices, but also legitimacy-creating devices that signal adherence to certain expected norms and behaviours to market participants.

Based on the actual and perceived quality of minority shareholder perception in various countries, Table 1 shows that adding perception to the actual quality of law is important, because by far not all countries' legal rules are correctly perceived. Indeed, there is approximately the same number of countries in each category (correctly perceived low-quality law, correctly perceived high-quality law, misperceived low-quality law, and misperceived high-quality law). In the case of Australia, for example, minority shareholders are objectively not particularly well protected according to international standards. Indeed, Australia's shareholder protection laws score below average in our sample. Yet, the perception of the quality of its shareholder law is above average indicating a mismatch between perception and actual law..

**Table 1. Perception of law in 54 home countries**

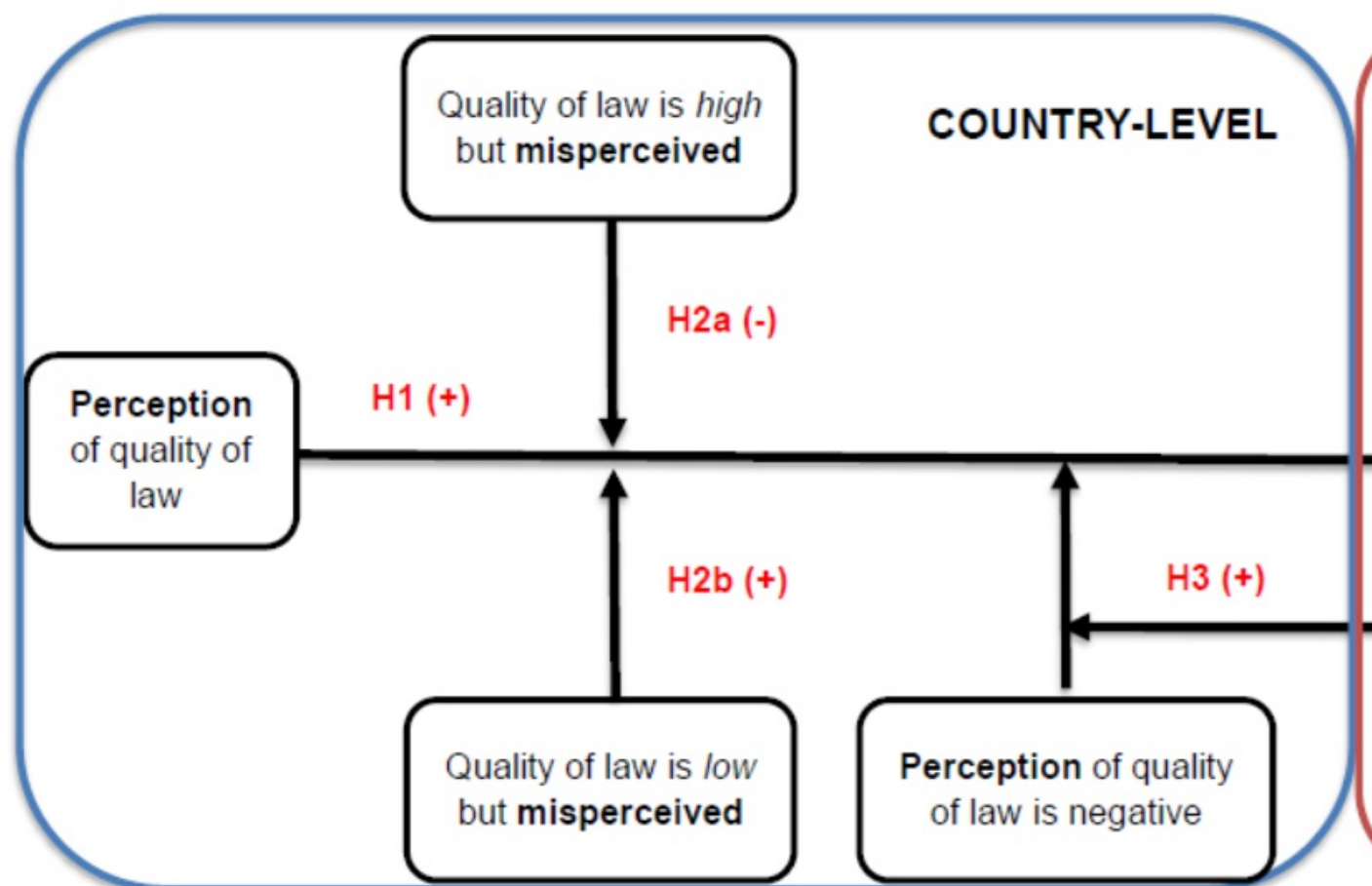
Correctly perceived low-quality law	Correctly perceived high-quality law	Misperceived low-quality law	Misperceived high-quality law
Argentina*	Belgium	Australia	Bulgaria*
Bangladesh*	Canada	Finland	Chile*
Brazil*	Denmark	France	India*
China*	Hong Kong	Germany	Pakistan*
Cyprus	Ireland-Rep	Luxembourg	South Korea
Egypt*	Israel	Netherlands	Spain
Greece	Japan	Oman*	Thailand*

Indonesia*	Malaysia*	Saudi Arabia*	Turkey*
Italy	Malta	Sri Lanka*	
Jordan*	New Zealand	Switzerland	
Kenya*	Norway		
Kuwait*	Singapore		
Mexico*	South Africa*		
Nigeria*	Sweden		
Philippines*	Taiwan		
Poland*	United Kingdom		
Russian Fed*	United States		
Tunisia*			
Vietnam*			
35.2%	31.5%	18.5%	14.8%
(19 of the 54 home countries)	(17 of the 54 home countries)	(10 of the 54 home countries)	(8 of the 54 home countries)

Notes: \* denotes emerging economies. [Source](#): *Legal Perception and Finance: The Case of IPO Firm Value*, *British Journal of Management*

Our research multi-level framework is presented in Figure 1. All of the hypotheses address the underdeveloped role of legal perception in IPOs, be it on its own (H1), or in conjunction with the actual quality of the law (H2a and H2b) and with firm-level corporate governance (H3).

#### Figure 1. Research model and hypotheses



Source: [Legal Perception and Finance: The Case of IPO Firm Value](#)

Our results provide strong support for the basic insight of the legal signalling view that what drives IPO valuation is not so much the actual quality of legal shareholder protection, but rather the perception of its law. In the case of strong actual legal shareholder protection, the effect of legal perception on IPO valuation is stronger if the perception is aligned with positive law than when the quality of law is misperceived.

We also find that in negatively perceived countries (perception below the average), higher levels of firm-level corporate governance affect IPO value. In other words, corporate governance practices can compensate for the negative legal perception. In positively perceived countries, firm-level corporate governance mechanisms do not impact the positive relationship between perception and valuation. One interpretation is that for such countries, the legal framework may be considered sufficient to guarantee a reasonable level of shareholder protection for investors. This hints at the contextual nature of the firm signalling effect, which depends not only on the level of actual legal shareholder protection, but also on its perception. It also supports the idea that firm signalling does not always have an impact on a firm's reputation. Our study hints at the shortcomings of existing theorisation of the role of law in the economy and suggests that measures of legal quality based on 'black letter law' may be insufficient to account for the role the law plays in the economy.



Notes:

- This blog post is based on [Legal Perception and Finance: The Case of IPO Firm Value](#), *British Journal of Management*.
- The post expresses the views of its author(s), not the position of LSE Business Review or the London School of Economics.
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